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IN THE

Supreme Court of the United States

October Term 1937

No. 667.

United States of America,
Petitioner,

v.

Harry A. Kaplan,
Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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PAGE

INDEX.

CASES CITED.

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Opinion Below.

The special findings of fact, conclusions of law, and opinion of the Court of Claims are reported in 18 F. Supp. 965.

Jurisdiction.

The judgment of the Court of Claims was entered April 26, 1937. A motion for a new trial was filed by the United States on June 24, 1937, and was denied by the Court on October 4, 1937. The jurisdiction of this Court is invoked under Section 3 (b) of the Act of February 13, 1925.

Questions Presented.

During the year 1929 the respondent sold 25 shares of stock in "1100 Park Avenue" for $250,000.00 and paid a commission on said sale of $10,000.00, leaving a net selling price of $240,000.00. The 25 shares of stock cost the respondent $46,000.00. The respondent reported on his Federal income tax return the sum of $194,000.00 as profit on the sale taxable for the year 1929. Said reported profit on the sale was computed by respondent by subtracting $46,000.00 (cost price) from $240,000.00 (net selling price).

However, under the terms of the agreement of sale the respondent received $25,000.00 down on the date of the sale of the stock and the balance of the purchase price was payable by the vendee in monthly installments of $1,875.00 each over a period of ten years.

In all, the respondent received from the sale during the year 1929 the sum of $30,625.00, which was less than 40 per cent of the amount of the purchase price of $250,000.00.

The Internal Revenue Agent in Charge at New York City subsequently notified the plaintiff that an over-assessment of $2,084.20 for the year 1929 would be recommended on the basis of the respondent's right to report the profit from the sale on the installment basis.

The respondent thereafter filed a claim for refund, which was denied by the Commissioner of Internal Revenue, on the ground that the respondent had no right to compute the profit on the installment basis after filing his return and showing a profit of $194,000. The respondent for the year 1929 kept his accounts and filed his Federal income tax return on the cash receipts and disbursements basis.

The case therefore presents the following questions:

I.

Whether a profit of $194,000 truly, correctly and reasonably reflects the respondent's income from the sale for the year 1929.

II.

Whether the respondent's error in reporting excessive income for the year 1929 may be corrected by the filing of a claim for refund.

III.

Whether the respondent is precluded from claiming the installment method for reporting profit on the sale by having filed his return on the basis of a completed profit of $194,000.

Statute and Regulations Involved.

The pertinent statute and regulations involved in this case are printed in the Appendix, *infra*, p. 13.

Statement.

The Court of Claims made the following special findings of fact:

1. A joint income tax return of plaintiff, Harry A. Kaplan, and his wife, Ethel, for the year 1929 was filed March 15, 1930, indicating a total tax of $2,084.20 which was paid—$584.20 on March 17, 1930, and the balance of $1,500 in the amount of $500 each on June 13 and October 16, 1930, and $500 on July 23, 1931. For 1929 and all subsequent years plaintiff kept his books of account and made his Federal tax returns on the cash receipts and disbursements basis.

Included in the gross income in the return was an amount of $194,000, being the difference between a net selling price of $240,000 and a purchase price of $46,000 paid in June 1928 for shares of stock in "1100 Park Avenue" which Harry A. Kaplan, April 11, 1929, agreed to sell under a contract whereby the purchaser was to pay $250,000 as follows: $25,000 down and $225,000 in monthly installments of $1,875 beginning October 1, 1929, together with interest, the shares in the meantime to be deposited in escrow. The plaintiff in 1929 paid $10,000 commission

on the transaction, making the net selling price to him $240,000. On December 28, 1929, plaintiff agreed to an assignment made September 23, 1929, by the purchaser of his obligations under the contract to a third party, the Comas Holding Corporation.

During 1929 plaintiff received from the purchaser or his assignee $30,625 on the sales contract; in 1930 he received $22,500 in monthly installments of $1,875; and in the first three months of 1931, $5,601.51, after which time the agreed payments ceased. By agreement of August 12, 1931, between Ethel Kaplan, to whom plaintiff has assigned his interest in the contract for a nominal consideration, and the Comas Holding Corporation, the balance of $191,273.49 was to be paid $2,273.49 down and $2,000 monthly beginning September 1, 1931. In 1931 there was paid to plaintiff on the revised agreement $6,273.49 to the end of October, at which time payments again ceased. A further agreement was entered into March 19, 1932, between Ethel Kaplan and the Samuel Silver Realty Co., Inc., whereby the former agreed to sell the same shares of stock to the latter for $75,000, payable $750 down and the balance in monthly installments of $750 beginning April 10, 1932.

2. Plaintiff filed a joint income tax return for himself and wife for 1930 on March 16, 1930, showing no taxable income and no sale of stock in "1100 Park Avenue" or profit or loss thereon. Plaintiff filed no income tax return either for 1931 or 1932.

3. Internal Revenue Agent in Charge, R. T. Miles, New York City, notified plaintiff by letter November 18, 1931, of his decision, after audit and investigation of the 1929 return, to recommend an overassessment of $2,084.20 for 1919 (the record shows this date to be 1919, but it should be 1929) conceding plaintiff's right to compute the tax on the sale here involved on the installment basis.

February 29, 1932, the Commissioner of Internal Revenue notified plaintiff of his disapproval of the internal

revenue agent's report and stated that no overassessment was disclosed.

4. March 12, 1932, plaintiff filed a claim for the refund of $2,084.20 for 1920, (the record shows this date to be 1920, but it should be 1929) on the ground that he was lawfully entitled to report the stocks-sale transaction on the installment basis. The Commissioner of Internal Revenue rejected this claim January 23, 1933.

Argument.

I.

No important question of Federal tax law is presented.

The issues in this case involve questions of fact and not substantial questions of law.

The Court of Claims found that the respondent erroneously and mistakenly reported a profit of $194,000 on the transaction herein involved in his return for the calendar year 1929 (R. 7).

The Court of Claims also found that the basis upon which the respondent reported the transaction in his return for the year 1929 did not clearly reflect the respondent's income (R. 8.)

The Court stated, in part, as follows (R. 8):

> "* * * Moreover, the basis on which plaintiff reported the transaction in his return for 1929 and the basis on which the Bureau held him taxable when the claim for refund was finally rejected in 1933 did not clearly reflect plaintiff's income. In March, 1932, almost a year before the Commissioner rejected plaintiff's refund claim, the contract of sale of the stock in question was changed and the then unpaid purchase price thereof was reduced to $75,000. *The maximum amount which plaintiff therefore could ever receive under the contract for sale of the stock was $139,999 instead of a net selling price of $240,000, which is $54,000 in excess of the sum stated as profit in the return for 1929.* * * *"

(Italics supplied.)

One of the objects of the statute providing for the filing of claims for refund is to enable a taxpayer to correct errors of fact (*Davis* v. *United States,* 71 C. Cls. 444, 46 F. (2d) 377.)

Accordingly the Court of Claims held that the respondent was entitled to correct the errors which he had made and to file a claim for refund and recover thereon.

II.

Section 44 of the Revenue Act of 1928 definitely gives to a taxpayer the right to report income from a casual sale of personal property on the installment basis. The mistake of this taxpayer in returning a fictitious profit, which did not truly and correctly reflect his income, did not constitute a binding election.

The wording of the law (Section 44, Revenue Act of 1928) which grants the taxpayer the privilege of reporting such a sale on the installment basis discloses no intent on the part of Congress to make a choice of one method or the other a binding election. The statute does not even use the word "election" in reference to installment sales of property. The statute merely states that the income from such a sale may be reported in the manner prescribed. Likewise, the Regulations (Regulations 74, Articles 352 and 353) do not even imply that a choice of reporting one or the other method in reporting the sale of property shall be construed as a binding election. There is nothing in the law or the regulations which makes respondent's original choice a binding election or which justifies the action of the Commissioner of Internal Revenue in refusing to allow respondent to make the change which he requested.

Furthermore, the situation presented here is analogous to that presented under the capital net gain provision of Section 101 of the Revenue Act of 1928. That section provides:

> "In the case of any taxpayer other than a corporation who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, *at*

the election of the taxpayer, be levied, collected and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½% of the capital net gain." (Italics supplied.)

In other words, the taxpayer may pay a tax at the rate of 12½% of his capital net gain or may report the capital net gain as ordinary income and pay the ordinary tax rate on it. It should be noted that this section specifically provides that the taxpayer shall *elect* the method which he desires to use. In spite of the use of the phrase "election of the taxpayer" in the statute, it has been consistently held by the Bureau of Internal Revenue and by the Board of Tax Appeals that a choice of one or the other method is not a binding election but may be changed after the return is filed, if it is advantageous to the taxpayer to do so. In G. C. M. 2367, Int. Rev. Cumulative Bulletin VI-2, page 172, in considering Section 206 (b) of the Revenue Act of 1921, which corresponds to Section 101 of the Revenue Act of 1928, the General Counsel of the Bureau of Internal Revenue stated in said Cumulative Bulletin:

> "It was evidently the purpose of section 206(b) of the Revenue Act of 1921 to allow taxpayers with respect to capital gains to compute the tax either under that section or under sections 210 and 211 whichever would produce the lesser tax. The parenthetical expression 'at the election of the taxpayer' as used in section 206(b) carried out this purpose and does not imply a technical election which once made is binding on the taxpayer. No real election is involved; that is, no election between two desirable alternatives, since obviously all taxpayers will desire to avail themselves of section 206 if it results in a lesser tax. In such a case, if that section is not availed of, it must be through ignorance or mistake."

In that memorandum the General Counsel ruled that a taxpayer who had filed his original return reporting his

capital net gain as ordinary income should be allowed to amend his return and be taxed at the rate of 12½% on his capital net gain. In G. C. M. 13466, published in September, 1934, in Internal Revenue Bulletin, Vol. XIII-1, page 144, the above rule was held to apply where at the time the original return was filed it was to the advantage of the taxpayer to return his capital net gain as ordinary income, but upon an audit of his return and an increase of his ordinary income, it became advantageous to the taxpayer to change his method of reporting said income and be taxed on his capital net gain at 12½%.

The above quoted portion of G. C. M. 2367 was approved and the rule reiterated as follows:

> "The conclusions reached in the foregoing rulings were based upon the theory that where a taxpayer has the right to be taxed at one of two rates he will always choose the lower rate, and that the 'election' to have capital gains so taxed really means the right to have such income taxed at the capital gain rate if it is more advantageous to the taxpayer. If the taxpayer does not elect to be taxed at the lower rate it will doubtless be due to ignorance or mistake and he should have the right to elect with full knowledge of all the facts and the consequences of an election. The possibility of a taxpayer electing to be taxed at the higher rate is too remote for contemplation."

See also I. T. 2132, IV-1 C. B. 117, *James F. Hoey* v. *Comm.*, 4 B. T. A. 1043; *Fifth Third Union Trust Co.* v. *Comm.*, 20 B. T. A. 88.

The reasons advanced by the General Counsel in the above quotations in support of his ruling, that a choice of one of the two methods of reporting capital net gain does not constitute an election, apply with equal force to Section 44 of the Revenue Act of 1928 and support respondent's contention in regard to that section of the law. It is equally true that in the case of an installment sale of property all taxpayers would desire to avail themselves of the method which would result in the lesser tax and a failure to do so "must

be through ignorance or mistake" and therefore there is no election between two desirable alternatives. There is no sound reason why a choice under Section 44 of the Revenue Act of 1928 should constitute a binding election when a choice under Section 101 of the same Act does not constitute a binding election, especially since Section 101 specifically provides that the method used shall be "at the election of the taxpayer." It is submitted that Congress did not intend that a choice by a taxpayer of one of the two methods allowed for the reporting of income from an installment sale of property should constitute a binding election, and that the Commissioner erred in so ruling and in refusing to allow respondent to correct the error made in the original return.

The instant case is distinguishable from the line of cases involving taxpayers on the accrual basis. If this taxpayer had been on the accrual basis of accounting and had reported the profit on the accrual basis as income for 1929, his return might have been correct for it would have reflected the profit for 1929 on the accrual basis of accounting. Accordingly he would not have had any error to correct by filing a claim for refund.

However, this taxpayer is on the cash basis of accounting. On that basis he did not derive a profit of $194,000 from the sale in 1929. On a cash basis his income for the year 1929 is distorted by reporting a profit of $194,000. On the accrual basis of accounting such a profit would perhaps have been correct. Therefore, inasmuch as the respondent reported for the year 1929 on a cash basis and reflected an erroneous and unreasonable profit from the sale, he is entitled to correct this error by means of a claim for refund. *Davis* v. *United States, supra.*

The United States Board of Tax Appeals has pointed out in a number of cases that a taxpayer is not irrevocably bound by electing to report income on an erroneous basis which either distorts income or fails to truly and correctly reflect income.

In *Key Largo Shores Properties, Inc.* v. *Commissioner of Internal Revenue*, 21 B. T. A. 1008, the Board of Tax Appeals said:

> "The fact that petitioner originally reported income from the sale of real estate on the installment basis does not preclude it from changing to the deferred payment basis where the installment basis does not correctly reflect income."

In the course of its opinion the Board declared as follows on page 1012 of 21 B. T. A.:

> "Under the Revenue Acts various methods of reporting income may be adopted by taxpayers, but all are designed to correctly reflect the true income in order that a just tax may be levied and collected. If a method used by a taxpayer does not clearly reflect income, the respondent may determine the income according to a method which in his opinion does clearly reflect it. Section 212, Revenue Act of 1926. This in itself is sufficient to demonstrate that it was not intended that taxpayers should be irrevocably bound by the election of a method of reporting when that method is erroneous. The effect in this case of requiring adherence to the basis originally adopted by the taxpayer would be to set up and tax, as income, an amount which in fact is not income. Neither administrative rules nor the forceful arguments in favor of administrative expediency can create income where in fact there is none, and, after all, it is only income that is to be taxed. In our opinion the installment basis when applied to the facts in the present case does not reflect the taxpayer's income."

In *Boone et al.* v. *Commissioner*, 27 B. T. A. 1064, the Board held that where income was originally reported on the accrual basis the taxpayer could later change to the installment basis in order to clearly reflect income. At page 1067 of 27 B. T. A. the Board said:

> "Respecting respondent's contention that because petitioners in their return for 1920 reported the profit

from the sale on an accrual basis they cannot now change to the installment basis, we again disagree. We have previously held that there was no statutory authority for reporting income on the installment basis under the Revenue Act of 1918, B. B. Todd, Inc., 1 B. A. 762; H. B. Graves Co., 1 B. T. A. 859; Hoover-Bond Co., 1 B. T. A. 929. Obviously, therefore, when petitioners filed their returns for 1920 they had no right to report the income from this sale on the installment basis. This privilege was accorded them by the provisions of section 212 (d) of the Revenue Act of 1926 as retroactively applied by section 1208 of the same act. To hold that petitioners can not change the method of reporting this installment sale would be contrary to the intention of Congress as expressed in these sections. Laurence H. Lucker, 21 B. T. A. 93; Potter Farms, Inc., 6 B. T. A. 111; Standard Computing Scale Co. v. United States, 52 Fed. (2d) 1018; M. L. Elken, 7 B. T. A. 1160; R. L. Brown Coal & Coke Co., 14 B. T. A. 609. Cf. Key Largo Shores Properties, Inc., 21 B. T. A. 1008."

III.

The facts in this case are distinguishable from the facts in *Pacific National Company* v. *Welch*, 91 F. (2) 590. The petitioner relies on the decision of the United States Circuit Court of Appeals for the Ninth Circuit in *Pacific National Company* v. *Welch*, 91 F. (2d) 590, and cites that case as the basis for the granting of a writ of certiorari in this case. The Court found as a fact in the Pacific National Company case that the taxpayer reported the sales there involved in its income tax return, just as the sales were reflected upon the books of the taxpayer; that is, the taxpayer company treated the sales on its books as deferred payment sales and measured its book income accordingly. There was no finding by the Court that either the books of the taxpayer or its return failed to truly and correctly reflect income. The Pacific National Company subdivided real property and sold the subdivision lots for 25 per cent down and the balance over a period of time and the obligations

of the various purchasers of the lots were treated as having a fair market value equivalent to their face value.

In the instant case but one transaction is involved; that is one casual sale of stock. The respondent is an individual and he did not have a set of books reflecting sales of property on a deferred payment basis as did the Pacific National Company. All the sums he received in 1929 were the cash payments made by the vendee and a contract of sale providing for the further payments.

The Court of Claims found in the case at bar that the return of the taxpayer for the year 1929 (showing a profit of $194,000 from the sale) did not truly and correctly reflect the taxpayer's income. The Court further found that the taxpayer erroneously and mistakenly reported in his return for 1929 a profit from the transaction of $194,000.

WHEREFORE, it is submitted that the reasons advanced by the petitioner for the granting of a writ of certiorari are not sound and the petition should be denied.

Respectfully submitted,

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APPENDIX.

Statutes and Regulations Involved.

The Revenue Act of 1928 provides as follows:

"(a) Dealers in Personal Property—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

"(b) Sales of realty and casual sales of personalty —In the case (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 40 per centum of the selling price, the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term 'initial payments' means the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made.

"(c) Change from accrual to installment basis.—If a taxpayer entitled to the benefits of subsection (a) elects for any taxable year to report his net income on the installment basis, then in computing his income for the year of change or any subsequent year, amounts actually received during any such year on account of sales or other disposition of property made in any prior year shall not be excluded."

Article 351 of Treasury Regulations 74 promulgated under the Revenue Act of 1928 provides, in part:

> "* * * In the case of a casual sale or other casual disposition of personal property other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, for a price exceeding $1,000, income may be returned on the installment basis provided the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale or other disposition is made do not exceed 40 per cent of the selling price. * * *".

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